

Federal Reserve Bank of Minneapolis



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Ms. Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
20<sup>th</sup> and C Streets, N.W.  
Washington, DC 20551

RE: Comments to Proposed Amendments to Regulation CC  
Docket No.: R-1176

Dear Ms. Johnson:

We have reviewed the proposed rule to amend Regulation CC and offer the following comments.

Clarification of Allocation of Responsibility

The Check 21 legislation generally places the legal burdens associated with the creation of substitute checks on the reconverting bank. In some circumstances, problems with a substitute check--e.g., a failure to accurately duplicate the MICR line of the original item--may arise from circumstances beyond the control of the reconverting bank. For example, this could occur if the original item contained non-standard use of "on-us" fields, the original was made of poor quality paper, or the original contained poor quality MICR encoding. We recommend that the commentary to the regulation address the allocation of legal responsibility when a party prior to the reconverting bank contributes to a subsequent problem with an item that is made into a substitute check.

MICR Line Requirements

Similarly, we recommend that the Board consider adding commentary to clarify the following issues related to the MICR line requirements:

- Under current practices, when an item rejects during processing, a party will place a "strip" on the item that is only encoded with the routing number and amount of the item. In a circumstance in which a substitute check is stripped and encoded without a 4 in position 44 by a prior bank before the item is image captured and reconverted into a subsequent substitute check, does the stripping bank provide an

encoding warranty and, if so, how will subsequent banks identify the bank that placed the strip on the item?

- What is the potential liability of a returning bank that creates a substitute check intended as a qualified return that contains a 2 instead of a 5 in position 44? Failure to place a 5 on the returned substitute check may cause the size of the item to shrink if it is subsequently reconverted from image to a substitute check later in the process. What is the obligation of a subsequent reconverting bank of that document when the image will be reduced in size to the point it may not be readable? The challenge in these two scenarios is that the reconverting bank will have no control of those items, yet it will provide the warranty and indemnity on them.
- What is the status of a substitute check that is created from an X9.37 file with an image of the original item that does not contain an encoded amount field? We recommend that this be clarified in the regulation with an example. The proposed commentary describes a missing amount as a type of error. Under current practice with regard to the electronic exchange of checks, the item would not require encoding for any purpose and would be missing the amount as a matter of practice, not as an error.
- What is the status of a substitute check of a qualified return with encoding that incorrectly identifies the bank of first deposit? May a party, such as a Reserve Bank, receiving such an item correct this encoding error or must the item be returned to the paying or returning bank for correction?
- What is the status of a substitute check made from an item that had been stripped with only the routing number and amount because the original MICR information was unreadable by the human eye? Is the substitute check a legal equivalent under such circumstances? Would this situation affect the warranty or indemnity obligations of the reconverting bank?

#### Indorsement Issues

We offer the following comments related to indorsement requirements of the proposed rule:

- It appears that the electronic indorsement of the depository bank placed on a substitute check (between 1.95 and 2.55 inches from the leading edge) could be overwritten and obscured by a bank indorsing as a collecting bank (current location defined as between the leading edge and 3 inches from the leading edge.)

We recommend that alternatives be explored before accepting this outcome from the draft X9.90 standard.

- We recommend that the rule clarify whether an electronic depositary bank indorsement is needed when the original item has the physical depositary bank indorsement captured on the image.
- The Board requests comments regarding the ability to indorse on the front of checks being returned. In our view, with the limited area available, indorsement on the front could make the image of the original item less readable and therefore, more likely the subject of warranty claims.

#### Subsequent Substitute Checks

We offer the following comments regarding definitions affecting subsequent substitute checks:

- Section 229.2.(zz) defines a substitute check in relevant part as a paper reproduction of the original check that “contains an image of the front and back of the original check.” When a substitute check of a substitute check is created, it is not clear from this definition that the second version of the substitute check would need to include more than the image of the original check, which we believe it must. For example, the second version would contain an image of the full back of the first substitute check, which includes both an image of the original plus any indorsements on the first substitute check. A strict interpretation of the definition could lead to the view that a substitute check of a substitute check only needs to contain the image of the original check.
- Section 229.51(a)(1) or its commentary should be clarified as to the validity of a substitute check of a substitute check. The section states that the item must only represent information on the front and back of the check at the time it was truncated. This section or its commentary should go on to state that a substitute check of a substitute check should capture all the relevant information from the original and the prior substitute check.

We appreciate the opportunity to comment on this important rulemaking.

Sincerely,

A handwritten signature in dark ink, appearing to read 'J. M. Lyon', with a stylized flourish at the end.

James M. Lyon